Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:HAR:TL-N-5001-01
CJSantaniello

date: AUG 27 2001

to: Dave Turgeon, Territory Manager (HMTC)

from: District Counsel, Connecticut-Rhode Island District,

subject: **Large Case Advisory -** [redacted]

This memorandum responds to your request for assistance dated August 14, 2001. This memorandum should not be cited as precedent.

In your memorandum, you request our legal advice regarding whether the taxpayer made a valid section 338(h)(1) election notwithstanding its failure to comply with the literal instructions to the Form 8023. For the reasons set forth below, we believe that the taxpayer did make a valid 338(h)(10) election because it complied with the instructions to the Form 8023 to the fullest extent possible. Even if, however, the taxpayer did not technically comply with the instructions, it still made a valid election because it substantially complied with the instructions.

Issues

1. Whether [redacted] and the shareholders of [redacted] made a valid joint election under I.R.C. § 338(h)(10) and Treas. Reg. § 1.338(h)(10)-1(d)(2) regarding [redacted]'s [redacted] stock acquisition of [redacted] and [redacted]. **UIL No. 338.01-00**

2. If [redacted] and the shareholders of [redacted] and [redacted] did not make a valid joint election under section 338(h)(10), whether they substantially complied with the provisions of Treas. Reg. § 1.338(h)(10)-1(d)(2). **UIL No. 338.01-00**

Facts

[redacted], a C corporation with a principal place of business in [redacted], Connecticut, is the common parent of a consolidated group. Based on the activity codes identified on its

returns, it would appear that [redacted] is in the LMSB for the Heavy Manufacturing, Construction, and Transportation Industry.

On [redacted], a [redacted] group subsidiary, [redacted], acquired [redacted] and [redacted], two small electing business corporations located in California. As part of the purchase agreement, the shareholders of [redacted] and [redacted] agreed to treat the purchases as qualified stock purchases pursuant to section 338(h)(1) and to execute Forms 8023, Election Under Section 338(h)(1) for Corporations Making Stock Purchases.

Properly executed Forms 8023 regarding [redacted]'s acquisition of [redacted] and [redacted] were attached to the final returns of [redacted] and [redacted] that were timely filed on [redacted], and to [redacted]'s consolidated return that was also timely filed on [redacted] However, original Forms 8023 were not filed with the District Director for the Connecticut-Rhode Island District at his prior address in Hartford, Connecticut.[1] Additionally, Forms 8023 were not filed with the Director, Field Operations (HMCT) at her office in Springfield, New Jersey. The due date for the filing of section 338(h)(1) elections in this case was [redacted].

Relevant Law & Analysis

1. [redacted] made a valid election under section 338(h)(10) relating to its [redacted] stock acquisitions of [redacted] and [redacted].

Section 338(a) allows a corporation (the purchasing corporation) that acquires the stock of another corporation (the target corporation) in a "qualified stock purchase" to elect to have the target corporation's assets take a value based on the amount paid by the purchasing corporation for the target corporation's stock. The term "qualified stock purchase" is any transaction or a series of transactions which takes place during a 12-month period in which the purchasing corporation acquires 80 percent of the stock of the target corporation. Section 338(d)(3).

Section 338(h)(10) provides that, under regulations prescribed by the Secretary, an election may be made under which the target corporation recognizes gain or loss on the sale of its stock as if it sold all of its assets in a single transaction. If a valid

---

[1] As of October 1, 2000, the Office of District Director ceased to exist as part of the reorganization of the Internal Revenue Service.

section 338(h)(10) election is made, no gain or loss will be recognized on stock sold or exchanged in the transaction by the target's shareholder. Treas. Reg. §§ 1.338(h)(10)-1(a), (e)(2).

A purchaser of a target's stock in a qualified stock purchase benefits from a stepped up basis in a section 338(h)(10) election. A section 338(h)(10) election results in a single level of tax imposed on the deemed asset sale. A section 338(h)(10) election can be made if the target corporation is an S corporation immediately before the acquisition date. Treas. Reg. § 1.338(h)(10)-1(a). If the target is an S corporation, it is the S corporation's shareholders who must incur the tax liability as a result of the election. Treas. Reg. § 1.338(h)(10)-1(e).

Section 338(h)(10)(C) requires in connection with a section 338(h)(10) election that the purchasing corporation and the target corporation furnish to the Secretary, as provided in the regulations, the following information:

(i) the amount of the purchase price allocated under subsection (b)(5) to goodwill or going concern value;

(ii) any modification of the amount described in clause (i); and

(iii) any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

Treas. Reg. § 1.338(h)(10)-1(d)(2) requires that a section 338(h)(10) election be made jointly by the purchasing corporation and the target corporation's shareholders on Form 8023 in accordance with the instructions to the form. A Section 338(h)(10) election must be made no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Section 338(g)(1); Treas. Reg. § 1.338(h)(10)-1(d)(2). Once made, a section 338(h)(10) election is irrevocable. Section 338(g)(3); Treas. Reg. § 1.338(h)(10)-1(d)(3).

The instructions to the Form 8023 provide as follows:

> A copy of Form 8023 must be attached to the final income tax return of the old target, to the first income tax return of the new target, and to the income tax return of the purchasing corporation for its tax year that includes the acquisition date; but failure to do so will not invalidate a section 388(h)(10) election.... In the case of a target that is an S corporation, attach Form 8023 to

the final income tax return of the S corporation with additional copies distributed to each electing S corporation shareholder with his or her Schedule K-1 (Form 1120S).

The instructions to the revised Form 8023 further provide that the Form 8023 should be filed with the District Director, to the attention of the Chief, Examination Division, for the IRS district where the purchasing corporation's corporate headquarters is located.

In this case, it is undisputed that [redacted] acquired the stock of [redacted] and [redacted] in a qualified stock sale because [redacted] acquired all of the stock on the same day (i.e., [redacted]). It is also undisputed that [redacted], [redacted], and [redacted] filed Forms 8023 with their timely filed [redacted] Forms 1120. The sole question, therefore, is whether the taxpayers complied with the remaining requirement in the instructions, namely, the timely filing of Form 8023 with the district director before the [redacted] due date.

As previously noted, original Forms 8023 were never filed with any district director. Although the taxpayers could have mailed the form addressed to the District Director for the Connecticut-Rhode Island District, that position had already been abolished by the due date as part of the reorganization of the Internal Revenue Service. Consequently, because it was impossible for the taxpayers to literally comply with this requirement, and inasmuch as the law generally does not require the performance of a futile act, it should be viewed as a nullity for purposes of determining whether the taxpayers made a valid section 338(h)(10) election in this case.

There is, however, an argument that the taxpayers did not make a valid section 338(h)(10) election because they could have filed the Form 8023 with the Director, Field Operations (DFO) for Heavy Manufacturing, Construction, and Transportation.[2] However, was no express requirement in the instructions to do so. In fact, the

[2] According to your memorandum, the Service had informally announced that LMSB taxpayers should file Forms 8023 with the appropriate DFO for the taxpayer's industry. We unaware of any such announcement.

instructions to Form 8023 have still not been modified to account for the reorganization. Thus, considering the absence of any guidance regarding the post-reorganization filing requirements, it would be wholly inequitable to impose them upon the taxpayers.

2. Even if [redacted] and the shareholders of [redacted] and [redacted] did not technically comply with the instructions to Form 8023, they still made a valid section 338(h)(10) election because they "substantially complied" with the provisions of section 338(h)(10) and Treas. Reg. § 1.338(h)(10)-1 under well established principles.

It is well established that in determining whether an election has been properly made absent adherence to literal requirements, a court should assess whether the taxpayer has "substantially complied" with the requirements, notwithstanding the "shall" and "must" language. Woodbury v. Commissioner, 900 F.2d 1457, 1460 (10th Cir. 1990). In assessing whether there has been substantial compliance, a court must ask whether the requirements are mandatory in nature, or merely procedural details established to facilitate the Commissioner's administration of the Internal Revenue Code. Columbia Iron & Metal v. Commissioner, 61 T.C. 5, 8 (1973). The focus of the inquiry is on whether the failure to comply with the literal requirements for the election goes to the "essence" of the provision, or whether it is a relatively ancillary, minor procedural infirmity. Atlantic Veneer Corp. v. Commissioner, 812 F.2d 158, 160-161 (4th Cir. 1987). Compare Young v. Commissioner, 783 F.2d 1201, 1206 (5th Cir. 986); Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 794-96 (11th Cir. 1984) (One essential purpose of Form 5003 required by Treas. Reg. § 1.167(a)-12(e) is to inform the Service that an election has been made.); Hewlett-Packard Co. v. Commissioner, 67 T.C. 736, 749 (1977) (Another factor in ascertaining whether an election provision must be literally complied with is the consequence of noncompliance.)

There are no reported cases addressing substantial compliance for section 338(h)(1) elections. In an analogous situation, however, the Eleventh Circuit in Knight-Ridder considered whether the taxpayer's failure to attach a Form 5006 to its tax return, as required by Treas. Reg. § 1.167-12(e)(3)(i), precluded it from using the Guideline Class Life System of depreciation. The taxpayer maintained that because it properly calculated depreciation under that method, it substantially complied with the regulation. The taxpayer also failed to check the appropriate box in Schedule G of the tax return to substantiate its election.

In Knight, the court rejected the taxpayer's substantial compliance argument, holding that the essential purpose of the regulation is to require a binding election and that this purpose is furthered by a clear manifestation to the government of the taxpayer's election. According to the court, a clear indication of the taxpayer's election to employ the class system is necessary to eliminate any dispute over whether the system applies and what the appropriate useful life should be. The court distinguished that case from those where the taxpayer had communicated the election to the Service but failed to comply with "minor procedural details." See Columbia Iron (failure to attach corporate minutes to election); Tipps v. Commissioner, 74 T.C. 458 (1980) (taxpayer filed required form, but failed to include certain information); Hewlett-Packard, (taxpayer filed required information, but attached it to wrong part of return).

In Knight, the court rejected the taxpayer's argument that the Service does not need an explicit election because it can discover the errors during an audit. According to the court, the Service needs to know that an election has been made to determine whether an audit is necessary in the first place and what its scope should be. It also found unpersuasive the taxpayer's argument that it had consistently calculated depreciation accurately under the class life system, reasoning that the failure to make an express election would leave room for the taxpayer to later argue that it had never intended to make an election.

We believe that technical compliance with Treas. Reg. § 1.338(h)(10)-1(d)(2) is not an essential element for an election under section 338(h)(10). Clearly, the primary purpose of filing Form 8023 with the District Director is to place the Service on notice of the section 338(h)(10) election. Although the Form 8023 filed with the District Director is the most critical of the three, at least one of the required Forms 8023 was timely filed to place the Service on notice of the election. Additionally, the remaining form, attached to Scapa's Form 1120 filed on [redacted], also notified the Service of the election. Moreover, the Forms 1120 filed by [redacted], [redacted], and [redacted] reported the transaction in a consistent manner, and, thus, the government was not disadvantaged in any way as a result of the taxpayer's failure to file Form 8023 with the DFO.[3]

---

[3] For example, the purchaser and the shareholders of [redacted] and [redacted] could have taken inconsistent positions between the deemed sale price and Adjusted Grossed-Up Basis of the targets' assets.

Conclusion

For the foregoing reasons, we believe that [redacted] and the shareholders of [redacted] and [redacted] made a valid election under section 338(h)(10). In our view, the proposed letter to the taxpayer from the Acting DFO, in which the Acting DFO states that "in the specific factual situation presented, [the Service] would not propose an examination adjustment solely due to the fact that a Form 8023 was not timely filed with the Director of Field Operations", does not constitute an informal grant of relief under Treas. Reg. § 301.9100, but rather a reasonable interpretation of whether the taxpayers made a valid election under the doctrine of substantial compliance.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later.

Please call Carmino J. Santaniello at (360) 290-4075 if you have any questions or require further assistance.

BRADFORD A. JOHNSON
Associate Area Counsel
LMSB, Area 1

By: _____
CARMINO J. SANTANIELLO
Attorney